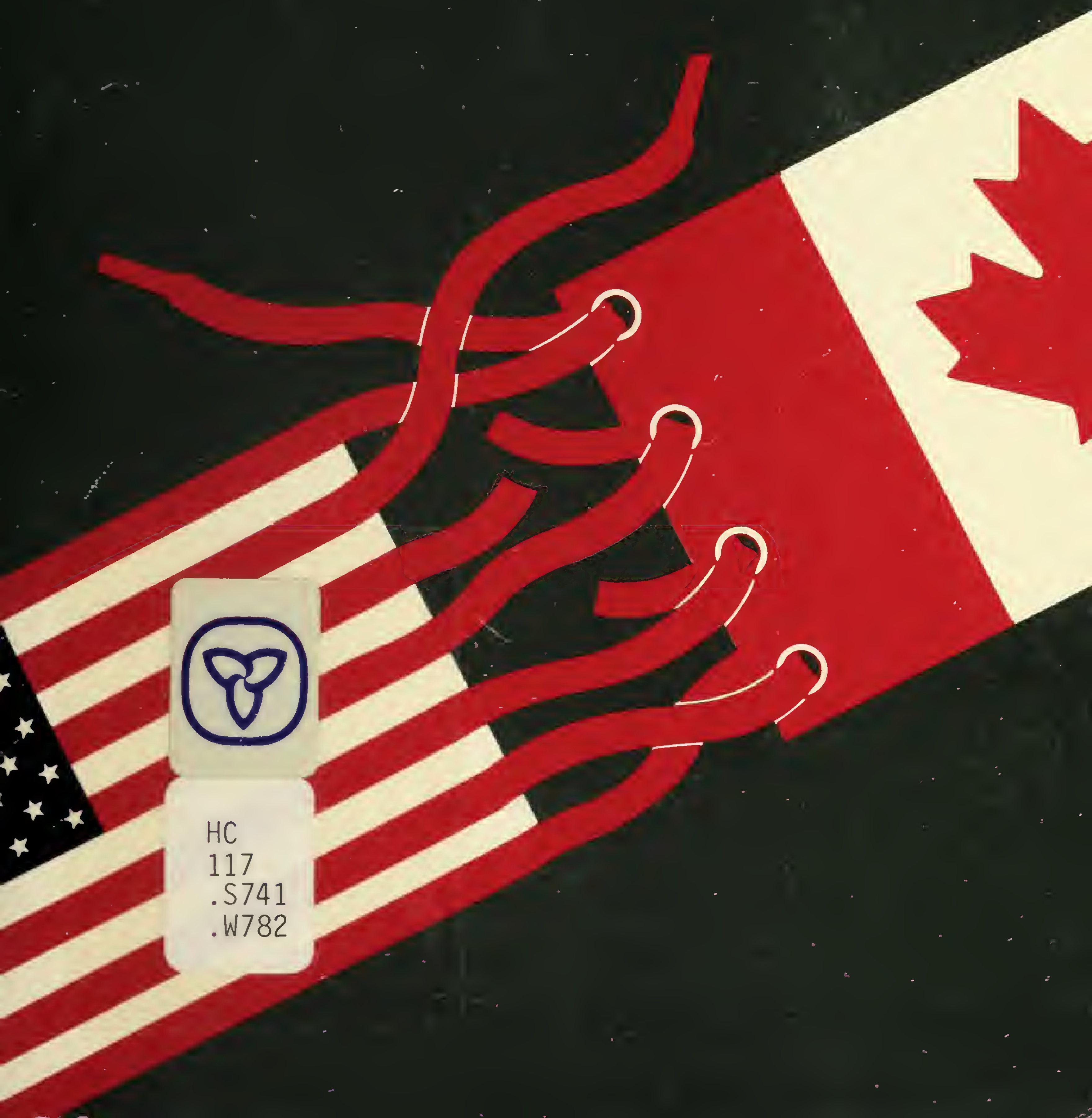
Canada/United States Free Trade: Problems and Opportunities

R.J. Wonnacott

ONTARIO ECONOMIC COUNCIL



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1
Introduction

The largest trade flow that has ever taken place between two countries is the one now occurring across the Canada/United States border. About three-quarters of Canadian trade is with the United States; as a consequence roughly one-fifth of Canadian GNP is generated by sales to the United States. This trade relationship is not as critical from the American point of view, but it is still extremely important. "The United States engages in far more trade with Canada than it does with any other country. Indeed, the United States carries on a surprising amount of trade with the province of Ontario alone. If Ontario were defined as a separate country then, as of 1983, it would be the largest market in the world for U.S. merchandise exports – larger than second-place Japan, with the rest of Canada in third place. Moreover, this U.S. export sale to Ontario would be larger than that existing between any other two countries at any time in history."

The barriers to Canada/U.S. trade have been coming down as a result of multilateral General Agreement on Tariffs and Trade (GATT) negotiations – in particular the Tokyo Round that is now coming into effect. But Canada and the United States have taken no *bilateral* action to reduce their trade barriers against each other across the board – in spite of the example provided by other regional initiatives, notably the European Economic Community.

This paper examines the economic benefits and costs to Canada and the United States of Canada/U.S. free trade. It also considers some of the possible provisions of a free trade agreement between

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the two countries and the technical and political hurdles that might be encountered on the way to such an agreement.

Before I proceed, I must emphasize three important points:

1 Free trade would involve an attack not only on tariffs but also on the growing list of non-tariff barriers or NTBs (e.g., quotas and government procurement policies such as 'Buy American'). Indeed, one of the advantages of a bilateral negotiation between Canada and the United States – relative to multilateral negotiations in the GATT – is that it would allow us to concentrate our efforts on the American NTBs that damage Canada most.[1]

2 When we talk of removing trade barriers, we must recognize that they cannot be eliminated altogether: tariffs can be completely eliminated, but NTBs cannot. In this respect, there is no 'complete free trade' even between states in the United States or between provinces in Canada. (For example, there are some non-tariff barriers between provinces.) Nonetheless, the states and provinces do benefit substantially from the relatively high degree of free trade that they now enjoy.

3 Even though the Tokyo Round is reducing tariffs substantially, it will not come nearly as close to eliminating them on our trade with the United States as it is now fashionable to believe. True, by the end of the Tokyo tariff cuts in 1987, a large percentage of our exports to the United States will be duty free. But one important reason why this will be so is that many of our exports to the United States (such as resources and autos) already flow through duty-free holes in the U.S. tariff wall. In 1987 there will still be a long list of manufacturing firms in Canada that will be deterred from exporting by U.S. tariffs. To be internationally competitive, many firms in Canada require specialized, large-volume plants, which can be justified only if there is assurance of continued access to the U.S. market; a treaty-bound zero U.S. tariff under a free trade agreement would provide much more assurance on this score than even a small non-zero tariff.

2
Canada/U.S. free trade: the Canadian view

In manufactured goods in which there are economies of scale and other advantages of a large market, it is not clear how Canadian industrialists, producing in a domestic market of about 20 million people, can compete with producers in Japan, the United States, or Europe, who have access to tariff-free markets of more than 100 million. Accordingly, Canada has supported multilateral trade liberalization in the GATT. In particular, the Kennedy and Tokyo Rounds have reduced the disadvantage that Canadian producers face by providing them with easier access to foreign markets. At the same time, Canadian consumers have benefited from easier, cheaper access to foreign goods. These are the two main reasons for considering a further step – a Canada/U.S. free trade agreement: allowing goods to flow freely between the two countries would give Canadian producers and consumers access to a 'domestic' market of more than 200 million people.

In evaluating the effects on Canada of such an agreement in a more detailed way,[2] it is important to distinguish between the effects on Canada of removing our own trade barriers against U.S. goods flowing north and the effects on Canada of removing U.S. trade barriers against our goods flowing south.

THE EFFECTS OF REMOVING CANADIAN BARRIERS AGAINS U.S. GOODS

This step would reduce the price within Canada of imports from the United States and of goods produced in Canada in competition with these imports. Moreover, with free entry into Canada, the quantity of imports would increase for two reasons, both beneficial to

Canada: (a) Canadians would increase their consumption of bargain-priced goods (both imports and import-competing goods); (b) to some degree, imports would displace higher-cost Canadian production. Technically speaking, we would be giving up products in which we have a comparative disadvantage in order to acquire them less expensively by importing them instead. (While employment in Canada would decrease as imports displaced some domestic production, there would be an offsetting tendency for employment to increase because our exports to the United States would increase as U.S. trade barriers came down.)

THE EFFECTS OF REMOVING U.S. BARRIERS AGAINST CANADIAN GOODS

The tariff that many Canadian industrial exporters presently pay at the U.S. border goes to the U.S. treasury. With the elimination of the tariff, Canadian exporters would no longer pay this 'tax' to Washington. In other words, the U.S. treasury would no longer collect this slice of income from Canadians. Instead, the income would be transferred back from the U.S. treasury to Canadian exporters and eventually to Canadian labour and other factors of production.[3]

This point applies to *existing* Canadian exports. The removal of U.S. trade barriers would also provide another, much more important source of benefit to Canada – the opportunity for Canadian firms to *increase* their exports to the United States. The resulting increased specialization in Canada in selected export lines where there are economies of scale would reduce manufacturing costs. This in turn would raise Canadian real income.

To sum up: With the elimination of trade barriers between the two countries, Canadian producers would rationalize – that is, they would specialize in a smaller range of goods, producing each good at higher volume and frequently at lower cost. In doing so, Canadian producers would be responding to both a carrot and a stick. The carrot would be free access to the large U.S. market. The stick would be the removal of the Canadian tariff, which would leave many Canadian firms unable to compete with less expensive imports unless they did rationalize and thus reduce their costs. The reductions in Canadian costs (that is, the increases in productivity) would eventually allow Canadian producers to increase their wages, reduce

their prices, or both. (Indeed, inexpensive imports would force them to reduce their prices.) Thus, because of a combination of lower prices and increased wages, Canadian real income would rise.[4] Estimates of these and other Canadian income gains that would result from bilateral removal of Canada/U.S. tariffs are very large – in the range of 5 to 10 per cent of Canadian GNP.[5]

But with the increase in our income, would the activities in which we engage change drastically? Specifically:

WOULD CANADIANS BECOME 'HEWERS OF WOOD AND DRAWERS OF WATER'?

It is true that removal of only our own tariff would move Canada in this direction, at least to some degree. The reason is that the Canadian tariff (like those of other countries) is escalated – that is, it is very low (or zero) on resources, but it rises as goods become more and more highly processed. Thus it provides its heaviest protection to manufactured goods, and if only this tariff were removed Canadian manufacturing would be likely to contract. While it is not clear that the resulting redirection of Canadian activity towards resource processing would be as damaging as Canadians sometimes assume (many oil exporting countries have discovered that 'drawing water' at \$20 to \$40 a barrel can be extremely rewarding), almost no one suggests a policy of removing only the Canadian tariff. Instead the issue is the removal of both the Canadian and the U.S. tariffs; thus we would be getting rid of a U.S. tariff that is also escalated – and that has consequently *deterred* Canadian export and production of highly processed goods. (These goods have to pay a high tariff at the U.S. border; we tend therefore to concentrate on exporting duty-free resources.)

In short, the Canadian tariff encourages us to concentrate on highly processed goods, while the U.S. tariff pushes us in the other direction, towards a concentration on resources. Given the largely offsetting effects of the two tariffs, it is by no means clear that their removal would push us more strongly in one direction than in the other. Indeed, the existing Canadian industrial corridor between Windsor and Quebec City is a reasonably good location for producing highly processed goods for Canada/U.S. distribution – provided there is free trade across the border. The reason is that this Canadian corridor lies along the northern edge of the largest market in North

America – that is, the Chicago/Boston/Washington triangle. In relation to this market, Toronto is a considerably better location than the 'out-of-the-way' Minneapolis-St. Paul area, which, despite its comparative remoteness, has nonetheless been able to attract and retain considerable industry in free trade competition with other U.S. locations.

3
Canada/U.S. free trade: the U.S. view

COSTS: THE LOSS OF TARIFF INCOME BY THE U.S. TREASURY

If Canadian exporters no longer had to pay duty to the U.S. treasury, there would be a clear benefit to Canada, as noted earlier. But this benefit to Canada would also represent a loss to the U.S.[6] While the benefit to the relatively small Canadian economy might be important, the corresponding loss to the much larger U.S. economy would be of far less consequence. It should be noted that the United States has already borne such a duty loss as a result of the Auto Pact. But even though the pact has become a sensitive issue, with each country expressing a number of complaints, the United States has not complained about its loss of duty revenue. There is no indication that the United States judges this loss to be important; indeed, there is no evidence that Americans have even noticed it. Accordingly, there is no reason for Canadians to make an issue of it.

ECONOMIC BENEFITS TO THE U.S.

Though there have been a number of friendly overtures, there has been no serious recent attempt by either Congress or the U.S. administration to promote the idea of Canada/U.S. free trade. This reflects the correct perception by Americans that such an initiative would kill the idea politically in Canada; it does not reflect an absence of benefits for the U.S.

An expanded market

Removal of Canadian trade barriers against U.S. goods would expand U.S. markets, providing gains to U.S. producers able to exploit

comparative advantage or economies of scale. But free access to Canada would expand the market available to U.S. firms by less than 10 per cent; would this increase generate significant benefits?

To get some idea of why the answer would be yes for many U.S. firms, suppose that the 5 to 10 per cent of the U.S. market that lies northwest of a line running from, say, Minneapolis-St. Paul to northern California were cut off from the rest of the United States by exactly the same trade barriers that now exist between Canada and the United States. Even though this is a geographically dispersed, relatively small part of the U.S. market, its loss would be important for many firms in the rest of the United States and crucial to some – especially those that just reach (or do not quite reach) their breakeven point before taking into account their sales in this slice of the market. Accordingly, the expectation is that many producers in the rest of the United States would react strongly, were they forced to bear the cost of such a 5 to 10 per cent reduction in their market. Yet their costs would be roughly the same as the benefit they would acquire from free access to the Canadian market. What is at stake in both cases is the potentially large change in the profit position of U.S. firms that could result from a geographically dispersed 5 to 10 per cent change in their market.

The potential benefit to U.S. firms of free access to Canada would exist even if the firms' costs of production were constant. However, in areas of manufacturing where there are economies of scale, increased sales volume would mean lower costs on *all* their units of output, and consequently even greater potential benefits.[7]

A free trade area would protect existing U.S. trade and investment in Canada

A proposal by Canada to set up a free trade area would leave the United States with the choice of saying yes or no. But whereas a 'yes' would draw the two countries together, a 'no' would be likely to push them apart. Indeed, if the Canadian approach were to occur when, because of increased U.S. protection, Canada viewed the status quo as no longer an option but had to choose between greater co-operation with the United States and a more protective nationalistic approach, then a U.S. refusal would guarantee a Canadian move in the protective, nationalistic direction.

Thus there are two broad economic reasons for the United States to respond favourably to a Canadian initiative: the first is that free trade with Canada would provide benefits; the second is that it would protect the United States against the loss of exports and the losses on its investments in Canada that would result if a rebuffed Canada were to embark on a more nationalistic set of policies.

While the picture is one of net economic gains for the United States that might be large in absolute terms, it is not clear that they would be large when measured as a percentage of the huge American GNP. But so long as the economic effects would be positive – no matter how small – this should be more than enough, given the past U.S. record of accommodation to the wishes of its partners. For example, the United States supported the formation of the EEC, even though this policy – and in particular the highly protective Common Agricultural Policy – involved substantial costs to the United States.[8] American support in this case (and in other cases) was forthcoming for political reasons – and there is no *a priori* reason to expect that similar support for a Canada/U.S. free trade area would be withheld.

POLITICAL ADVANTAGES FOR THE U.S.

While U.S. support for the EEC was tempered by the possibility that the EEC might make Europe more protectionist, there is no such possibility in the proposal considered here: Canada/U.S. free trade would, by its very nature, make Canada a *less* protectionist partner. Given the number of hostile relationships that the United States already has to deal with, a strong political case can be made in the United States for a policy of accommodating a key partner – a policy that should increase the chance of future co-operation, rather than the chance of conflict.

But the incentive for the United States may be more than just the defence of an existing relationship. It is possible that the two countries might view Canada/U.S. free trade as a basis for a broad new initiative to 'get North America moving again'. The task of revitalizing Canada/U.S. industry would be encouraged by an important (and, paradoxically, a protective) side-effect of a free trade area: industry in each country would get protection from third-country competition in the market of the other country. Thus, Canadian producers would enjoy duty-free access to the United

States, but their competitors in, say, Germany or Japan would not. Similarly, U.S. producers would get preference in the Canadian market *vis-à-vis* overseas competitors. Because tariffs are escalated – that is, higher on industrial products than on primary products – this 'market trading' effect would be stronger in highly processed industrial goods than in primary products.

Thus it is a reasonable expectation that the U.S. would respond favourably to a Canadian initiative. But there is, of course, no guarantee. Negotiations we enter into – on trade or any other issue – are never guaranteed to be successful. The normal procedure is for a country to decide what is in its interest, and then attempt to negotiate it.

4
What form? Free trade area, customs union, or common market?

All three methods allow participating countries to remove the trade barriers between them in a way that is consistent with the GATT (in particular, Article XXIV, which sets out the requirements of a free trade area). It is very much in Canada's interest to fully conform to GATT regulations (a point I shall return to later), since GATT now provides a small country's bottom line of defence against restrictive measures imposed by a large country. Indeed, a Canada/U.S. free trade area should be designed not only to be consistent with GATT and avoid weakening it,[9] but also, if possible, to strengthen it. For example, serious consideration should be given to extending any Canada/U.S. agreement to include a broad (but probably not complete) range of services – a step of apparent mutual benefit and current U.S. interest. A Canada/U.S. free trade agreement that extended coverage into the wide area of service activities not included in previous free trade treaties would provide continued momentum towards liberalized world trade during a period in which there may not be much progress on other fronts. (This is, incidentally, another reason why the United States might find such a free trade area attractive.)

Let us now consider the three specific forms:

A CUSTOMS UNION

Under a customs union, Canada and the U.S. would have to agree to a common external tariff on imports from third countries. Because of

its relative size, Canada could scarcely hope for equal influence in establishing this tariff; hence commercial policy would be made, by and large, in Washington. Quite apart from the concerns such a situation would cause in Canada, a common commercial policy would create problems because of the prerogatives of the U.S. Congress in setting U.S. trade policy. Finally, a customs union would not allow Canada to reduce protection against third countries without getting the United States to agree to do the same. For these reasons, I shall not consider a customs union further.

A FREE TRADE AREA

This is the form of economic association typically recommended for Canada and the United States, because under it each country would have a greater degree of independence: it would be free to independently set its tariff against third countries. Thus a source of U.S. domination over Canada implicit in a customs union – namely, the preponderant influence that the United States would have in setting trade policy *vis-à-vis* third countries – would be absent. Since each member would be allowed to reduce its tariffs against third countries, a free trade area would tend to be less protectionist than a customs union. It would also be more open-ended: that is, it would be easier to expand it to include new countries because this step would require no negotiation of a new external tariff or, alternatively, no requirement that new participants conform to an existing external tariff.

A COMMON MARKET

In common usage, the phrase 'common market' can mean almost anything: for example, it is often used to describe a free trade area or a customs union. But its most precise definition is 'what the Europeans have' – that is, a customs union with special attempts to co-ordinate the policies of the member countries. Such an arrangement would be unsatisfactory not only because it would be a customs union with a common tariff against third countries, but also because it would involve a self-conscious attempt to co-ordinate other policies as well. Any such co-ordination beyond the minimum required (as noted in the next section) is unlikely to be viewed by

Canadians as desirable, and it would not in any case be necessary to the achievement of most or all of the economic benefits of free trade.

To sum up this section, two points should be emphasized. First, a free trade area does *not* imply a common labour pool or, for that matter, any other form of economic agreement, such as a common currency. (Indeed, we shall argue below that, at least during the period of adjustment, a flexible exchange rate would be preferable to the fixed exchange rate that would prevail under a common currency.) Second, undertaking any of these forms of economic union *does not* automatically launch the participants into an irreversible and irresistible escalation, with the eventual result of complete economic and political union. Indeed, no free trade area has ever led to political union. Economics is not the controlling force in the political sphere that it is often supposed to be. In this regard, the century-old prediction of Friedrich Engels – well known in other contexts as an early proponent of economic determinism – might be noted:

> Here [in Canada] one sees how necessary the feverish speculative spirit of the Americans is for the rapid development of a new country . . . ; in ten years this sleepy Canada will be ripe for annexation . . . . And they may tug and resist as much as they like; the economic necessity of an infusion of Yankee blood will have its way and abolish this ridiculous boundary line.[10]

But the boundary line is still there, and so are the customs houses.

5
Political and technical problems

Even if Canada and the United States were to select a free trade area – the form of economic association that minimizes political and negotiating complications – political concerns would nonetheless arise.

THE PROBLEM OF CANADIAN VULNERABILITY

A Canada/U.S. free trade area would be a much more irreversible option for Canada than for the United States. The relative size of the two countries leads to this conclusion. In a fully rationalized Canada/U.S. economy, firms in the United States would have only limited dependence on the Canadian market (less than 10 per cent of the Canada/U.S. market is in Canada), while firms in Cananda would be heavily dependent on the U.S. market. Accordingly, while the reintroduction of trade restrictions in such circumstanes might do considerable damage to the United States, it would involve a much heavier cost for Canada. Thus an American threat to terminate the agreement[11] would give the U.S. a bargaining lever that would be very difficult to resist and might conceivably be exercised to influence Canadian policy in quite unrelated noneconomic areas.

It is important to keep this problem in perspective. It is not new; it is the traditional Canadian problem that would, in a sense, be made worse. It is a problem that would arise because under a free trade agreement our already high degree of dependence on the U.S. market would increase. But is there much chance that the United States would terminate such an agreement? Such an action seems very unlikely, because the United States could be severely hurt by the Canadian response. For example, the Canadian government might

impose a large across-the-board increase in the tax on U.S. investment in Canada. While each country has, from time to time, engaged in policies that have damaged the other, neither wants anything approaching outright economic war, because both recognize that this would involve an extremely high economic cost to both countries.

Nonetheless, it is true that, no matter what we do, we cannot *guarantee* against new U.S. trade restrictions; if we were to become adjusted to a free trade area, such restrictions would be much more costly for Canada. On the other hand, a free trade area would make such restrictions less likely – not only because the United States could not impose such restrictions against Canada without the drastic step of terminating the free trade treaty, but for another reason as well. A free trade treaty with the United States would provide Canada with an exemption from U.S. trade restrictions aimed at third countries (not only Europe and Japan, but also the rapidly industrializing countries of Southeast Asia, whose exports have been growing so rapidly). In the past, the United States has provided such exemption for freely traded goods. An example occurred when the United States, under balance of payments pressure, increased its tariffs in 1971. Although this action was aimed at third countries, it still fell on many Canadian exports – but not on automobiles, because they were being freely traded under the Canada/U.S. Auto Pact. In any free trade negotiation, Canadians should seek to 'embed such exemptions in cement', or get some similar sort of guarantee that Canada would not be damaged by U.S. action against third countries.

In short, a free trade area would make the cost to Canada of U.S. trade restrictions greater, but their risk less. Thus we would become more vulnerable to a change in U.S. trade policy in one respect, but less vulnerable in another.

WOULD THE UNITED STATES SEEK TO LINK FOREIGN INVESTMENT POLICY TO TRADE NEGOTIATIONS?

In my view, the appropriate Canadian response to any such U.S. attempt is clear: we should decide – with ample benefit of hindsight – which parts of our policies that now restrict foreign investment (in particular, which provisions of FIRA and the National Energy Program) are not in Canada's long-run economic interest. We should then make a necessity of virtue by allowing the United States, in the course of tough negotiations, to 'force' us to give up these provisions.

Thus we would kill two birds with one stone: such 'concessions' would both increase our bargaining power in gaining free access to the U.S. market *and* get rid of our own economically costly restrictions on foreign investment, which, for political reasons, we may have great difficulty in getting rid of otherwise. (There is an analogy here with tariff bargaining: one country bargains down the other's tariffs by giving up its own costly tariffs, which, for political reasons, it cannot get rid of otherwise.)

WOULD THIRD COUNTRIES OBJECT?

The most serious complaint might come from Europe. But it is not clear how the Europeans – given their own more protectionist common market and the numerous preferences they have granted to countries on the periphery of the EEC – could credibly object; moreover, in some European quarters, there is a feeling of surprise that, in a world of increasing numbers of regional free trade arrangements, one of the most obvious of all – that is, one between Canada and the U.S. – has not been undertaken.

Nonetheless, if the Europeans did strongly object, we might consider making the Canada/U.S. free trade area open to full European participation. It is unlikely that the Americans would agree to this, and even less likely that the Europeans would consider any such offer. But in the extremely unlikely event that the Americans and Europeans did agree to it, then this Canadian initiative would have triggered a serious approach to free trade by the United States and Europe, lack of which in the past has been the main stumbling block to much more complete multilateral free trade. In such an extremely unlikely set of circumstances, the original Canadian initiative to the United States would result in large and unforeseen worldwide benefits.

EMPLOYMENT RISKS

Trade liberalization is like technological change. The whole point is to increase efficiency and income, *not* employment. Yet if the past is any guide, one of the major hurdles in negotiating a free trade agreement will be concern by Congress and the Canadian government about its employment effects.

Indeed, it is this concern on the Canadian side that has led to the proposal in some quarters of rationalizing (scaling up) Canadian production first and then moving to free trade, rather than doing both simultaneously by establishing a free trade area. While theoretically the two approaches could lead to the same result, there are at least two problems with the policy of scaling up Canadian production first: (a) since it would not be forced by foreign competition, there is a substantial risk that it would simply not be accomplished – or, if it were accomplished, that it would involve the wrong set of activities; (b) Canadians would be undertaking the costs of rationalization without simultaneously enjoying the benefits of a removal of U.S. trade restrictions. Scaling up production in Canada would involve a number of serious problems unless Canadian producers simultaneously got access to a much larger market. It is all very well to say 'Let's do it in the Canadian market alone – let's concentrate on a very few models of each good, and in that way achieve economies of scale'. The problem is that Canadians would not necessarily benefit. True, we would get lower cost goods, but we would sacrifice variety. The only way to ensure benefit from high-volume specialization is to increase our exports of the specialized items and use the proceeds to pay for the imports that provide variety. In short, full benefits to Canada from scaling up cannot be realized without increased exports – that is, without freer access to large foreign markets. Free trade with the United States would give us that, but a purely domestic policy of rationalization would not.

To sum up, there is no way of acquiring the benefits of a large market without actually getting into it, as we would under a Canada/U.S. free trade agreement. But this still leaves a key question: the adjustment to Canada/U.S. free trade would involve unemployment risks and other short-run dislocation costs; how might these be minimized?

6
Timing measures to reduce adjustment costs

Precedents – such as the EFTA, the EEC, and the Kennedy and Tokyo Rounds – suggest that dislocation costs from reducing trade barriers may be less than expected and can be covered without undue pain. However, it would be wise to take special precautions, especially on the Canadian side of the border, where most of the adjustment to Canada/U.S. free trade would occur.

PHASED-IN TARIFF CUTS

One recommended way of phasing in tariff cuts over a ten-year period would be to have each country annually cut each of its tariffs by either one-tenth of its original level or 1 percentage point – whichever is larger. For example, a 12 per cent Canadian tariff would be cut by 1.2 per cent per year and would thus be eliminated in ten years. If the corresponding U.S. tariff were 5 per cent, then it would be cut by 1 per cent a year, thus disappearing in five years. (Many U.S. nuisance tariffs would disappear even more quickly.) In this example, years five to ten in the tariff-cutting period would provide Canada with a 'window of opportunity' during which our producers would have free entry into the United States while still retaining some protection in the Canadian market. Since U.S. tariffs are now typically lower than Canadian tariffs, such windows of opportunity would not be uncommon and would provide Canadians with some compensation for the higher cost of adjustment they would have to face.

FLEXIBLE TIMING OF EACH TARIFF CUT

In a world of gyrating exchange rates, such relatively modest phased-in tariff reductions of roughly 1 per cent per year might be little noticed. There is, in addition, a further subtlety in timing available that would make the tariff cuts even less visible. The scheduled Canadian tariff cut of, say, 1 per cent for any specific year could be introduced at the time during that year when the flexible Canadian dollar had decreased in value. In this way the buffering effect of the exchange rate on Canadian industry could be fully exploited. (Of course, pressure from tariff cuts would be brought to bear on Canadian industry, but only with a 'bounce-back' in the Canadian dollar.) This timing of tariff cuts would also tend to reduce the inflationary pressure generated by the decreased value of the Canadian dollar.

INITIATION OF CANADA/U.S. TARIFF CUTS WHEN THE TOKYO ROUND OF MULTILATERAL CUTS IS COMPLETED IN 1987

An economic case can be made for initiating Canada/U.S. tariff cuts as soon as possible. The longer we delay, the longer Canadian industry – and especially those firms that have already expanded to service the U.S. market – will be encumbered directly by the U.S. tariff (which acts as a border tax on Canadian output) and indirectly by the Canadian tariff. (The Canadian tariff schedule has a complicated effect on any specific Canadian industry. Although the industry's own tariff protects its output, this protection is partly offset – in some cases, more than offset – by tariffs on its inputs, which raise its costs.)

However, no matter how quickly we move now, it is difficult to see how a free trade agreement could be negotiated and initiated before the current Tokyo Round of tariff cuts is completed in 1987. Moreover, this timing is consistent with the two countries' invoking the 'interim agreement' rather than the 'declaratory' procedure[12] under Article XXIV of the GATT. (Under the interim agreement formula, Canada and the United States would submit a plan and schedule to the GATT for the creation of a free trade area. This procedure would inform other GATT members and allow them to make recommendations. It is the procedure that other applicants have used in the past; in none of these cases have formal recommendations been made by excluded countries.)

If tariff cuts were initiated in 1987 and stretched over a ten-year period, Canadian protection would not be removed until 1997, late in the next decade. Accordingly, the problem for Canadians would not be so much losses on existing assets as getting the next generation of capital investment pointed in the right direction. Concretely, for typical manufacturers in Ontario or any other province, the adjustment to increased international competition would not end when the Tokyo Round cuts are completed in 1987. Instead, the process of adjustment would be extended to 1997. The only major difference would be a change in focus – more concentration on meeting U.S. competition and less on meeting competition from third countries. (These countries would still be generating pressure on us simply because of their ability to produce low-cost goods. However, unless we were to have another multilateral round during that period – as indeed we might – we would not be reducing our barriers against their goods. Moreover, we would be acquiring an advantage in competing with these countries in the U.S. market; our exports would be acquiring free entry into the U.S. market, whereas their exports would still encounter U.S. trade barriers.)

But in a broader sense the process of adjustment will never be complete. It won't be complete in 1987 or 1997, regardless of what we negotiate or do not negotiate with the United States. Given the current rapid advances in technology, the Canadian economy will have to adjust in the future to large external shocks. A free trade arrangement with the United States would be only the first step in that process – and quite possibly not the most dramatic. However, raising ourselves to a competitive footing with U.S. industry would make it less difficult for us to adjust to the continuing international shocks we shall have to face in any case.

7
Other measures to reduce adjustment costs

Before I turn to some specific recommendations, it should be noted that two institutions already in existence should help to reduce the short-run costs of adjustment to free trade with the United States. The first, already noted, is our flexible exchange rate, which should provide some protection against a rapid influx of imports into Canada and a loss of employment here. Second, the presence of U.S. multinationals in Canada might also make the adjustment easier, since they would already have the facilities for distributing the newly specialized output of their Canadian plants throughout the United States.

What are the additional ways to buffer the Canadian economy from severe adjustment costs?

IMPORTANT TRIGGER POINTS

One approach to consider is a variation of the Swedish/EEC free trade triggers that would allow Canada or the United States to invoke controls on imports if they exceeded an agreed-upon growth rate. Such a brake on imports would prevent a too-rapid displacement of employment in either country. (However, Canadians should recognize that if these provisions were symmetrical, they might be invoked by the United States – just as the EEC has invoked this mechanism against rapid imports from Sweden.)

EMPLOYMENT OR VALUE-ADDED GUARANTEES FOR CANADA

The more specific the attempt to protect existing Canadian employment patterns, the greater the administrative difficulties and

the greater the likely resistance of U.S. negotiators. Many of the problems encountered under the Auto Pact – plus some new ones – would have to be faced, were we to attempt to include value-added or employment protection in a broader, across-the-board free trade arrangement.

But if this approach does prove feasible, any such guarantees should be short term, with a clearly defined termination date. Even if we could get long-term guarantees, it is difficult to argue that they would be in the Canadian interest. As already noted, we are certain to face international shocks in the future, and it is essential that we develop an economy that will adjust to these changes. The difficulty with long-term employment guarantees is that they create an economy with built-in resistance to adjustment. They tend to block the shift of activity towards sectors of comparative advantage and generate problems in controlling the wage level. Thus, if there are to be employment guarantees, they should be clearly stated to be short term. Short-term guarantees are almost certainly all that we could negotiate in any case – indeed, we would probably be lucky even to negotiate them – because of misunderstanding over the Auto Pact guarantees (were they temporary or permanent?) and because, unlike import trigger points, such guarantees would be asymmetrical, providing protection to Canada but not to the United States.

ADJUSTMENT ASSISTANCE

This can take many forms: government-backed loans, special R & D grants, or accelerated depreciation for Canadian firms rationalizing in order to expand into the U.S. market.

How would such measures be financed? One suggestion is this: as the Canadian tariff is reduced, prices in Canada will fall. The government could capture part of this price reduction with a temporary sales tax that would then be used to subsidize Canadian industry through the adjustment period. In this way, some of the short-run adjustment costs to Canadian industry would be paid for by the Canadian consumers who benefit from the tariff cuts.

Any such subsidies would have to be explicitly recognized as part of the agreement and therefore exempt from U.S. countervail (i.e., a U.S. tariff imposed to offset a foreign subsidy to firms exporting to the United States). No such problem would be involved in subsidies paid not to firms but to people who have been displaced – for

example, portable wage subsidies and retraining grants. Such subsidies would be the essential bottom line in any broad program of adjustment assistance.

COMPETITION POLICY

In order to facilitate the rationalization of Canadian production in response to free trade incentives and pressures, Canada should relax its restrictions on mergers of firms that produce traded goods. For these products, adequate protection against monopoly abuse would be provided by the competitive pressure of increased imports.

8
Other provisions

BORDER CONTROLS

Since each member of a free trade area sets its own external tariff, third countries have an incentive to ship their goods into the member country with the lower external tariff, from which they can then ship them duty free into the other member country. To prevent such deflections of trade, Canada and the United States would have to establish 'rules of origin' stipulating that imports from the other country must satisfy requirements of national content in order to qualify for free entry.

A MONITORING AGENCY

For such a broad agreement, an agency to handle disputes and appeals would be essential. (A number of misunderstandings and complaints might have been reduced or avoided had such an agency been established for the Auto Pact.) Canada should seek an agency with equal representation from the two countries that would make binding decisions on matters of appeal – even though this arrangement, like any other binding international agreement, would involve some sacrifice of Canadian autonomy. The problem is that the United States would also be obliged to sacrifice some autonomy, so it is not clear that such a strong monitoring agency could be negotiated. A more realistic expectation might be the establishment of an agency that would make strong but non-binding recommendations to the two governments.

9
Conclusions

Since Canadian businesses would have to bear much of the short-run risk and adjustment cost of free trade with the U.S., they have traditionally been a source of opposition to free trade proposals. But there is now evidence that this opinion has shifted. Canadian firms, through professional associations such as the Business Council on National Issues, the Canadian Chamber of Commerce, and the Canadian Manufacturers' Association, are no longer opposed on balance to a bilateral initiative to liberalize our trade with the U.S. In some cases, they have taken the initiative in this direction; at the time of this writing, Canadian business seemed to be leading, rather than following, the Canadian government.

The position of Canadian manufacturers is of particular interest. In a 1980 presentation to the Senate Standing Committee on Foreign Affairs, the Canadian Manufacturers' Association (CMA) reported on the roughly one thousand replies to a nationwide survey of its member firms on the question 'what would be the net impact on your company of Canada/U.S. free trade?' The answer: roughly one-third of the responding firms expected to contract, about one-third expected no change, and about one-third expected to expand. This apparent neutrality of Canadian manufacturers seems to represent a surprising change in attitude: two decades ago, at least in my casual observation, opposition by manufacturers far outweighed support. (The results of the questionnaire are all the more remarkable because they do not provide a greater weight to larger companies, which on average more heavily favour trade liberalization.) Since issuing this questionnaire, the CMA has dropped its strong opposition to

Canada/U.S. free trade and has called for a consideration of all trade options, including bilateral free trade with the United States.

There is good reason to view this (at least) neutral attitude as a strong confirmation of the case for free trade. Manufacturing executives – and labour – are the groups that would have to face the risks of free trade. And if these groups judge the risks to be offset by expected benefits from freer access to the U.S. market, then we are left with the essentially undiluted benefits that would go to other sectors of the Canadian economy; for example, to consumers, who would face lower prices, and to resource and service producers, who would face lower input costs.

Nonetheless, risks and dislocation costs will confront Canadian manufacturers as they go through the 'cold shower' (the term used by the British to describe their entry into the EEC). It is the combination of likely short-term costs and long-term benefits that has, it seems to me, made Canadians defer this policy from one generation to the next – with each generation perhaps regretting that the policy was not undertaken by the last. But the longer we defer, the more we will miss opportunities to 'get in on the ground floor' in the exciting new industries that are now being born. In many such industries (though not all) delay involves serious costs: the longer we wait and the more established the industry becomes, the greater the difficulties we shall encounter in trying to break into it.

To keep the adjustment problem in perspective, we should note that we are incurring more and more adjustment costs simply in order to maintain the *status quo*. Even if we freeze our tariff policy (which, in practical terms, means restricting any changes in our tariffs to those agreed upon in the GATT), we shall still face an increasing problem of adjustment to the explosive penetration of our market by producers in the Far East. The experience of the European auto industry is instructive: its adjustment has been not just to inter-European free trade, but also to increased competition from the Japanese. If the members of the EEC had recognized, at its formation, that they would have to adjust to both, they might have viewed the cost as excessive. But it can be argued that it has been precisely the adjustment to inter-European free trade that has given the Europeans a more competitive auto industry. This in turn has been one of the factors that has made the adjustment to Japanese imports less painful.

AN INITIATIVE NOW?

Until fairly recently, the major question has been: What would be the net benefits to Canada of moving from our present position to a freer trading arrangement with the United States? However, another question is now also being asked: What would be the further benefits to Canada of being able to secure our *present* access to the U.S. market? In other words, our *present* level of exports to the United States is threatened by a build-up of protectionist pressures in the United States. While these pressures always exist, they have recently become stronger because of the large U.S. budget deficit. By keeping U.S. interest rates higher than they would otherwise be, this deficit has drawn a large flow of capital into the United States. This capital flow in turn has raised the value of the U.S. dollar and made it exceedingly difficult for U.S. firms to compete against imports. In these circumstances, it has been hard for the U.S. administration to resist appeals for relief in the form of protection from imports. As we look to the future, it is not clear how long President Reagan will be able to resist protectionist pressure from Congress, especially as his second term starts to run out. Nor is it certain, in the longer view, that the next U.S. president will even be philosophically committed to freer trade.

Thus a major argument for a free trade agreement is to secure our present access to the U.S. market in a period when the United States may become increasingly protectionist. There is no doubt whatsoever that there would be risks and uncertainties in adjusting to free trade with the United States. However, we also face risks and uncertainties from the alternative strategy of 'taking our chances' as U.S. policy develops. Moreover, in the case of Canada/U.S. free trade, the risks would be offset by large export benefits that cannot be acquired in any other way.

What would happen if there were a strong resurgence of U.S. protectionisms that seriously damaged our access to the U.S. market? In such circumstances, the *status quo* would disappear as an option for Canada, and we would have little choice (short of a costly South-American style shift to a more protected and isolated economy) but to seek some form of bilateral trading accommodation with the United States. But because of the increase in U.S. protection, this would be the worst possible time to try to negotiate freer trade; it

would be even more difficult then than it would be now to get U.S. agreement to provisions to reduce Canadian adjustment costs.

NOTES

1 It is true that in attempting to bilaterally negotiate a reduction in American NTBs we would not benefit from the bargaining support of Europe and Japan. But there would also be problems in having Europe and Japan as 'bargaining partners' in a multilateral negotiation: they would set the agenda, concentrating on the American NTBs that hurt themselves, rather than us; moreover, the United States would be unwilling to reduce its NTBs without matching concessions from Europe and Japan.

2 For much more information on this proposal, see the Senate Standing Committee on Foreign Affairs' recommendation of a Canada/U.S. free trade area in (1982) *Canada/United States Relations, Vol. III: Canada's Trade Relations with the United States* (Ottawa) and the Economic Council of Canada's (1975) *Looking Outward* (Ottawa). The present abbreviated summary of the issues draws heavily upon these sources – and upon previous writings by the author. (For reservations about a Canada/U.S. free trade area, see B. Wilkinson (1982) 'Canada/U.S. free trade and some options', *Canadian Public Policy*, October.

3 Since removal of the U.S. tariff would transfer income from the United States to Canada, why wouldn't removal of the *Canadian* tariff transfer income in the other direction – from Canada to the United States? The reason is that, because of the relative sizes of the two economies, prices of industrial goods are typically set in the United States rather than Canada. Canadian importers, accordingly, must take the U.S. price as given, and therefore must raise the price of imports as they come into Canada by the amount of the Canadian tariff. Thus the Canadian tariff collected by Ottawa is paid by Canadians (namely by Canadian consumers, who pay a higher price). In other words, the Canadian tariff transfers income *domestically* – between groups *within* Canada; the U.S. tariff transfers income *internationally* – from Canada to the United States.

(To state this technically: in North America, it is the United States rather than Canada that determines the terms of trade in industrial goods between the two countries. Therefore the terms of trade between the United States and Canada are not affected by a change in the Canadian tariff, but they are affected by a change in the U.S. tariff.)

4 The specific way in which the real income gain would manifest itself (i.e., the specific combination of price reductions and wage increases) would depend on the degree to which the Canadian dollar was allowed to float.

5 See D. Cox and R. Harris (1984) 'A quantitative assessment of the impact on Canada of sectoral free trade with the United States' (a paper presented to the 1984 Annual Meetings of the Canadian Economics Association) 11; R.J. Wonnacott and Paul Wonnacott (1967) *Free Trade Between the United States and Canada* (Cambridge, Mass.: Harvard University Press) ch. 15; and R.J. Wonnacott (1975) Canada's Trade Options (Ottawa: Economic Council of Canada) ch. 15.

6 There is another reason why the U.S. treasury would lose duty revenue. Americans would switch some of their import purchases from a cheaper source (such as

Europe or Japan) to Canada. The reason for this 'trade diversion' would be the preferential treatment provided to Canadian goods; they would get free access to the U.S. market, while imports from other countries would still pay the U.S. tariff. (While Canadian goods would be cheaper than, say, Japanese goods ***to the U.S. individuals and firms that purchased them***, they would be more expensive to the U.S. *as a nation*. The reason is that the U.S. treasury, which previously collected duty revenue on imports from Japan, would now lose that revenue because these goods would be coming in from Canada duty free.)

It should be emphasized that this does not apply to *all* new U.S. imports from Canada, but only to those that displace cheaper goods available abroad.

There would also be a trade diversion cost to Canada to the degree that we switched our import purchases from less expensive third countries to the United States. However, this is unlikely to be important, because the United States is already the cheapest source of supply for Canada in a wide range of products; these products we would *continue* to buy from the United States – that is, diversion would not occur.

7 Whereas U.S. firms would be expanding in most lines of activity, in some they would be contracting because of new Canadian competition. But the expectation of benefits remains, a point that may most clearly be seen by considering a firm that produces ten goods at roughly a breakeven point on each. Suppose that as a result of trade liberalization the firm has to give up one of its breakeven activities, while expanding the other nine. On these nine, it produces above its breakeven point and makes a profit where none existed before.

8 The only way of arguing that the EEC provided net benefits to the United States is to argue that it generated a much more rapid rate of European growth (and hence more purchases from the United States) than would have occurred otherwise. But this is very speculative territory, since we simply do not know what would have occurred otherwise. It is for this reason that I have not used a parallel argument – namely, that the United States would benefit from more rapid Canadian growth in a Canada/U.S. free trade area. Incidentally, there is a stronger argument of this sort in the Canadian than in the European case: estimates of the real income gains for Canada fall in the range of 5 to 10 per cent or more of GNP, while estimates for the EEC fell in the range of 1 per cent or less.

9 As even the more protectionist EEC has shown, the formation of a free trading region can be consistent with the GATT, and thus allow parallel progress in multilateral trade liberalization.

10 Karl Marx and Friedrich Engels (1953) *Letters to Americans, 1848-1895: a Selection*. A. Trachtenberg, ed., L.E. Mins, trans. (New York) 204.

11 The right of unilateral termination by each country would have to be recognized, but strictly limited. For details, see Canadian-American Committee (1965) *A Possible Plan for a Canada/U.S. Free Trade Area* (Washington and Montreal).

12 Under the declaratory procedure, the two countries simply declare that a free trade area between them *already exists*. It has been conservatively estimated that by 1987, when the Tokyo tariff cuts are complete, 80 per cent of Canada's exports to the United States will be duty free, as will 65 per cent of our imports from the United States. I have already noted that in very important respects this is nowhere near free trade – but it still puts Canada and the U.S. closer to free trade than

other regional groups have been when they formed free trading arrangements without objection in the GATT. Hence Canada and the United States could be deemed to qualify under this clause. But the problem with this procedure is that it may be viewed by other GATT members as 'too cute' for such important trading nations to invoke; accordingly, these members might object to Canada/U.S. NTB liberalization, which is not covered by this declaratory GATT procedure. (Such NTB liberalization is essential, and it *is* covered by the interim agreement formula recommended here.)

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